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Washington, DC 20405

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

March 1, 1996

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Subject: <u>Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1.</u>

DOCKET FILE COPY ORIGINAL

Dear Mr. Caton:

Enclosed please find the original and nine copies of the General Services Administration's Reply Comments for filing in the above-referenced proceeding. Copies of this filing have been served on all interested parties.

Sincerely,

Jody B. Burton

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Assistant General Counsel
Personal Property Division

Enclosures

cc: International Transcription Service, Inc.
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Industry Analysis Division (Computer disk)

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

REPLY COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

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March 1, 1996

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SUMMARY

The Commission's original, primary and continuing statutory responsibility is to ensure that carriers possessing market power do not price their services above a just and reasonable level. As the agency vested with the responsibility for acquiring telecommunications services on a competitive basis for use of the Federal Executive Agencies, GSA has long supported the Commission's price cap plan for the regulation of local exchange carriers. In these Reply Comments, GSA responds to the comments and proposals of parties wishing to change this plan.

GSA agrees with U S West that it is time for the Commission to move away from complex models and "dueling economists" in the determination of the appropriate price cap X-Factor. The Commission can do this by implementing a five year moving average X-Factor according to the Historical Revenue Method as originally proposed by AT&T.

GSA agrees with those parties proposing that a LEC be given the opportunity to choose between X-Factor options having different sharing requirements. Specifically, GSA recommends that each LEC be allowed to select an X-Factor from among three options each year. The middle X-Factor would be based upon LEC industry past performance as calculated according to the Historical Revenue Method. Under this option, a LEC would be required to share half of its earnings in excess of 100 basis points above the target rate of return. The second option would allow a LEC to choose an X-Factor one percent higher than industry past performance. In return, the LEC would not be required to share its earnings until they exceed the target by 300 basis points. The third X-Factor option would be one percent lower than industry past performance.

With this option, the LEC would have to share half of all of its earnings in excess of the target rate of return. GSA concurs in the nearly unanimous opposition of commenting parties to the modification of price cap rules as competition evolves in LEC markets. Instead, GSA recommends that the Commission eliminate price cap regulation altogether for LEC services which become fully competitive in individual markets.

Finally, faced with a wide range of conflicting proposals, GSA supports AT&T's recommendation that the next LEC price cap performance review be scheduled for 1998.

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REPLY COMMENTS OF THE
GENERAL SERVICES ADMINISTRATION

The General Services Administration ("GSA"), on behalf of the Federal Executive Agencies, submits these Reply Comments in response to the Commission's Fourth Further Notice of Proposed Rulemaking in CC Docket No. 94-1 ("Fourth NPRM"), FCC 95-406, released September 27, 1995, and certain issues related to the Commission's Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1 ("Second NPRM"), FCC 95-393, released September 20, 1995. In these NPRMs, the Commission requested comments and replies on proposed changes to its price cap plan methodology.

I. INTRODUCTION

In comments filed on December 18, 1995, GSA urged the Commission to implement a five year moving average X-Factor for use in the price cap formula based upon the Historical Revenue Method.[1] GSA also recommended that the Commission allow each local exchange carrier ("LEC") to select an X-Factor appropriate to its

[1] Comments of GSA, pp. 3-5.

operations from among three options with different sharing requirements.[2] Finally, GSA recommended that the Commission schedule its second triennial price cap performance review in 1997.[3]

Voluminous comments in this proceeding were also filed by the following parties:

- The United States Telephone Association ("USTA") and eleven individual LECs;
- Three interexchange carriers ("IXC's");
- MFS Communications Company, Inc. ("MFS");
- The Telecommunications Resellers Association ("TRA");
- The International Communications Association ("ICA"); and
- The American Petroleum Institute ("API").

In these Reply Comments, GSA responds to the comments and proposals of these parties.

II. COMMENTS ON FOURTH NPRM

Issues 1 and 2 - The Historical Revenue Method Should Be Used To Calculate The X-Factor.

Most LECs support the use of a Total Factor Productivity ("TFP") approach to determining the X-Factor in the price cap formula.[4] In particular, the LECs endorse a

[2] Id., pp. 5-8.

[3] Id., p. 9.

[4] See, e.g., Comments of Pacific Bell and Nevada Bell ("Pacific"), pp. 1-2; the Southern New England Telephone Company ("SNET"), p. 5; the Lincoln Telephone and Telegraph Company ("Lincoln"), pp. 2-4.

specific TFP methodology prepared by Christensen and Associates and included with the comments of USTA.[5] Under this approach, the X-Factor would be the difference between the latest 5 year average of LEC TFP and U.S. TFP. For the 5 year period ending 1994, the X-Factor would be 2.78 percent according to USTA's calculations.[6]

No IXC or end user supports USTA's TFP approach. AT&T Corp. ("AT&T") presents a comprehensive analysis of the USTA model and concludes that it is "replete with a number of serious methodological errors, and it substantially understates the LECs' actual rate of productivity."[7] AT&T has developed its own TFP model which it contends corrects for the deficiencies in USTA's model. According to AT&T's model, the productivity for the LECs' interstate access services grew at a rate of 7.3 percent per year from 1985 to 1994. Including a .5 percent Consumer Productivity Dividend ("CPD"), AT&T recommends a base X-Factor (with sharing) of 7.8 percent.[8]

There are two primary reasons for the significant difference between the proposals of USTA and AT&T. First, USTA's proposal is based upon total company TFP, while AT&T's proposal is based upon interstate TFP. According to AT&T's calculations, interstate TFP is 1.93 percent greater than total company TFP.[9] Second, USTA's proposal assumes that LEC input prices increase at the same rate as the Gross Domestic

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[5] Comments of USTA, Attachment A.

[6] Comments of USTA, p. 3.

[7] Comments of AT&T, p. i.

[8] Id., p. iii.

[9] Id., Appendix A, p. 76, Table 7 (4.94 percent less 3.01 percent).

Product Price Index ("GDP-PI"). According to AT&T's calculations, the GDP-PI has gone up at a rate that is 2.54 percent greater than the increase in LEC input prices.[10] In both of these cases, GSA believes that the USTA's position is untenable, and AT&T's position is correct.

USTA and some LECs contend that TFP is only economically meaningful at the total company level because most inputs are shared and economically inseparable.[11] AT&T, however, concludes that there are "reasonable procedures to measure separately the LECs' interstate productivity growth and the productivity growth for the LECs intrastate and local services."[12] AT&T states:

> In sum, because the LECs' productivity for interstate access services differs markedly from their productivity for intrastate and local services, the Commission must use separated data "to ensure that interstate rates remain just and reasonable." See Fourth Further Notice, ¶ 63.[13]

The NYNEX Telephone Companies ("NYNEX") also recognize this flaw in the USTA method and state:

> However, although NYNEX agrees with the TFP methodology for measuring total company productivity, intuitively the higher output growth rates for interstate indicated a potential need for an adjustment to the TFP result....Basing the

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[10] Id.

[11] See, e.g., Comments of USTA, pp. 27-31; GTE Service Corporation ("GTE"), pp. 21-22; Southwestern Bell Telephone Company (SWBT"), pp. 12-14.

[12] Comments of AT&T, p. 16.

[13] Id., p. 17.

> productivity offset on only a total company TFP and not accounting for the higher revenue generation (output growth) in interstate may result in interstate revenues not aligning with the underlying separated interstate costs. Although as NERA states, separated costs do not reflect underlying economic costs for the interstate jurisdiction, interstate earnings are nonetheless based on separated costs, and as such provide the Commission with information that may bear upon reasonableness of interstate rates. For these reasons, the Commission should consider such an adjustment based on sound economic rationale to ensure a final reasonable Baseline X-Factor offset.[14]

MCI Telecommunications Corporation ("MCI"), TRA and API all argue that the use of a total company TFP in the interstate X-Factor calculation would result in a "windfall" to the LECs.[15]

GSA agrees with these parties. The Commission must not allow theoretically pure economic rhetoric to obscure the obvious: the X-Factor in the interstate price cap formula must be based upon interstate data. If the Commission believes an interstate TFP is not meaningful for theoretical reasons, then it must abandon the TFP approach to setting the X-Factor. The use of a total company X-Factor in the interstate price cap formula is inappropriate on both a theoretical and a practical basis.

The second major flaw in USTA's methodology is that it ignores the fact that LEC input prices have increased much less than the GDP-PI since divestiture.[16] The

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[14] Comments of NYNEX, pp. 20-21 (footnote deleted).

[15] Comments of MCI, p. 2., TRA, p. 9; API, p. 5.

[16] Comments of AT&T, pp. 11-13.

Commission has already concluded that a TFP based X-Factor should include an adjustment to reflect changes in LECs' input prices.[17] Sprint Corporation ("Sprint") agrees "because input prices are a key determinant to a LEC's unit cost of output."[18]

USTA and some LECs argue that over the long-term there is no statistically valid difference between the change in LEC prices and the GDP-PI.[19] U S West Communications, Inc. ("U S West"), however, states:

> While U S West believes that over the long term the input price differential ("IPD") between LECs and the rest of the economy will be zero, the inclusion of a short-term IPD arguably achieves the Commission's goal that gains by LECs in reducing unit costs are passed through to consumers. Therefore, U S West supports the Commission's proposed use of a short-term IPD in calculating the X-Factor if a PCI adjustment factor is deemed essential.[20]

GSA believes that under the TFP approach the input price differential must be calculated for the same period as the productivity rate. If, for example, the productivity rate is calculated for the latest 5 year period, then the input price differential should be for the same period. The mixing of a short-term productivity rate calculation and a long-term input price differential is inherently distortive and subject to manipulation.

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[17] NPRM, para. 54.

[18] Comments of Sprint, p. 3.

[19] Comments of USTA, pp. 25-27; Bell Atlantic, pp. 11-13; BellSouth Telecommunications, Inc. ("BellSouth"), p. 15.

[20] Comments of U S West, p. 7.

In summary, therefore, if a TFP approach is used to determine the X-Factor, the calculations must be based upon interstate data and adjusted for the input price differential. USTA's methodology does not have these characteristics and must be rejected. AT&T's methodology meets these requirements and should be accepted if the Commission adopts the TFP approach.

GSA recommends, however, that the Commission not use a TFP approach in setting the X-Factor. U S West observes:

> Since the inception of price caps five years ago, the selection of an appropriate X-Factor has been contentious, mainly because the X-Factor is based on complex, controversial, and somewhat subjective economic models which attempt to measure the difference between the productivity of LECs and the productivity of other industries as a whole. There is no longer a need to continue this unproductive debate because a much simpler plan is available to the Commission.[21]

GSA agrees with U S West's observation, but not its recommendation.

U S West recommends that the Commission simply freeze price cap levels at their current levels.[22] Given that recent and expected inflation rates are less than half of the appropriate interstate X-Factor, U S West's proposal would represent a huge windfall to the LECs. Such an outcome is totally inconsistent with the provision of interstate access at just and reasonable rates.

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[21] Id., p. 3.

[22] Id., pp. 3-5.

On the other hand, GSA agrees with U S West that it is time for the Commission to move away from complex models and "dueling economists."[23] The Commission can do this by adopting the Historical Revenue Method of calculating the X-Factor, as recommended by GSA in its initial comments.[24] As originally proposed by AT&T, this method simply determines what X-Factor would have resulted in constant earnings over the price cap period under examination.[25]

The Commission mischaracterizes this method, however, by stating that it "reprices access services over a historical period to achieve a target rate of return."[26] This is not at all true. This method simply determines what the actual X-Factor was for a period, without regard to a "target." When used as described below, this method provides rewards for those LECs which can realize efficiency gains which exceed the past performance of the average LEC. GSA believes this simple methodology is consistent with the basic intent of the price cap plan and should be adopted.

Issue 3 - The X-Factor Should Be Based Upon A Five Year Rolling Average.

USTA and most LECs recommend that the X-Factor be based upon a five year rolling average.[27] USTA states:

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[23] Id., p. 4.

[24] Comments of GSA, pp. 3-4.

[25] NPRM, para. 77-83.

[26] Id., para. 81.

[27] Comments of USTA, pp. 34-36.

> Also, as discussed in Section 11.B. infra, with a rolling average TFP factor, the productivity gains of all price-cap LECs will be captured over time, and thus there is no incentive for intertemporal cost shifting to avoid incurring sharing obligations in any particular period. The FNPRM also correctly notes that an X-factor calculated as a moving average would be superior to a fixed factor in that a moving average X-factor could function to both reflect the dynamics of LEC performance and flow-through recent productivity gains.[28]

AT&T and MCI recommend the use of a fixed X-Factor to be updated every three or four years.[29] MCI explains its position as follows:

> One of the key principles guiding the Commission when it initially adopted price cap regulation was the reduction of administrative burden on both the industry and the regulator....The Commission now proposes to require the LECs to file extensive data on both their costs and their demand in order to compute a TFP-based X-factor. This represents a sharp departure from the goals that underlie this proceeding....[30]

GSA agrees that the use of a rolling average X-Factor based upon the complex and controversial TFP method would create significant and unnecessary administrative burdens on both the industry and the Commission. The focus of the Commission should now be on implementing the Telecommunications Act of 1996 ("Act"), and the focus of the industry should now be on the marketplace, not arcane theoretical models.

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[28] Id.

[29] Comments of AT&T, pp. 33-34; MCI, pp. 14-17.

[30] Comments of MCI, p. 15 (footnote deleted).

By adopting the simple and mechanistic Historical Revenue Method, as discussed above, the Commission can ensure that the X-Factor remains current while avoiding the administrative burdens properly decried by the IXCs. A five year (or shorter) rolling average calculated on this basis would minimize the administrative burden on both the Commission and the industry while retaining the benefits cited by USTA above.

Issues 4 and 5 - Each LEC Should Select Between Three X-Factors With Different Sharing Requirements.

In its Comments, GSA recommended that each LEC be allowed to select one of three X-Factors each year based upon its expectations of performance in the following year.[31] The middle X-Factor would be based upon the LECs' five year moving average of past performance according to the Historical Revenue Method, as described above. A LEC choosing this option would be required to share excess earnings on a 50/50 basis with ratepayers. Excess earnings would be defined as earnings in excess of a 100 basis point "no sharing zone" above the authorized rate of return. If the carrier expects to do relatively well in the next year, it could select an X-Factor which is one percent higher. In return for the larger rate reduction which would result from this selection, the LEC's no sharing zone would be extended by two percent. Conversely, if a LEC expected its performance to be less than average, it would be allowed to select an X-Factor which was one percent lower than the five year moving average. The no-sharing zone would be eliminated for such a LEC.

[31] Comments of GSA, pp. 5-8.

There was widespread support for the linking of sharing requirements with X-Factor selection.[32] AT&T states:

> Therefore, as the Commission has recognized, multiple X-Factors would be of no value in the absence of meaningful sharing requirements that induce the LECs to pick the productivity measure appropriate for its economic circumstances.[33]

ICA notes that "LECs should continue to have the flexibility to choose between at least two X-Factors, because of the inevitable variations in different LECs' cost and demand changes."[34]

The options proposed by GSA represent a balancing of LEC and ratepayer interests. None of these options place an absolute cap on an individual LEC's earnings. A LEC can achieve earnings far above its cost of capital if it outperforms the average LEC. On the other hand, as long as the LECs retain significant market power, ratepayers will share appropriately in such success. GSA's plan also provides a lower X-Factor option for LECs whose prospects are temporarily below average. In any case, it is important to note that every year, under every option, every LEC is provided with a clear and certain financial incentive to control its input prices and maximize its productivity.

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[32] See, e.g., Comments of MCI, pp. 19-22; Sprint, pp. 9-12.

[33] Comments of AT&T, p. 37.

[34] Comments of ICA, p. 10.

Issue 8 - The Next Performance Review Should Be Scheduled for 1998.

In its Comments, GSA recommended that the Commission schedule its second price cap review in 1997 to examine LEC performance in the second three years of the plan.[35] Some LECs suggested that performance reviews would not be necessary if a moving average X-Factor was prescribed.[36] U S West suggested a limited review in three years and a full review in five years.[37] AT&T recommended a limited review annually and a full review in 1998.[38]

GSA believes that the Commission's original plan to schedule a performance review every three years has proven to be prudent. The first triennial review in 1994 resulted in a significant correction to the inadequate X-Factor originally prescribed. Such a schedule would suggest a second triennial review in 1997. GSA believes, however, that the implementation of the Act will continue to deserve industry and Commission attention in 1997. In light of this, and assuming that the Commission implements a rolling average X-Factor calculation, GSA believes that the next price cap performance review should be scheduled for 1998.

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[35] Comments of GSA, p. 9.

[36] See, e.g, Comments of SWBT, p. 40; GTE, pp. 44-45; Ameritech, p. 13.

[37] Comments of U S West, p. 28.

[38] Comments of AT&T, p. 47.

III. COMMENTS ON SECOND NPRM

Issues 19 and 20 - Price Cap Regulation Should Be Eliminated For Services Which Become Fully Competitive.

NYNEX recommends that the X-Factor applicable to a LEC be reduced as the level of competition faced by the LEC increases.[39] Ameritech recommend that the mere removal of competitive entry barriers should trigger a reduction in the X-Factor for a LEC.[40]

In a rare showing of consensus, virtually all other commenting parties disagree with these proposals.[41] Sprint states:

> Furthermore, competition - as suggested by NYNEX or otherwise - is not an appropriate criterion for granting LECs additional productivity factor options, especially on the record before the Commission. There is no record evidence of a direct correlation between competition and productivity and little record of the existence of meaningful competition. Given that competition in the access services market is in its infancy, at best, there is, and can be, no factual evidence to support such a proposition at this time.[42]

USTA adds the following:

> Moreover, the price cap plan is designed to be a transitional mechanism to a competitive

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[39] Comments of NYNEX, pp. 4-12.

[40] Comments of Ameritech, pp. 10-12.

[41] See, e.g., Comments of BellSouth, pp. 44-46; Bell Atlantic, pp. 17-19; MCI, pp. 43-44.

[42] Comments of Sprint, p. 12 (footnote deleted).

> environment, not a long-term regulatory regime. The result of increased competition will be that competitive services are removed from price cap regulation. See, e.g., Second Further Notice, para. 9. Linking pricing flexibility to the productivity offset utilized in the interim step of price cap regulation could serve to confuse the issue.[43]

GSA agrees that there should be no link made between the presence (or absence) of competition and the X-Factor. Services over which LECs possess market power should be subject to rigorous but fair regulation, as described above. Services which become effectively competitive should be promptly removed from price cap regulation.

The Commission should not apply half-hearted regulation to LECs possessing pricing power under any circumstances. If the marketplace is not restraining LEC pricing, the Commission must. That is the Commission's original, primary and continuing statutory responsibility.

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[43] Comments of USTA, p. 44.

IV. CONCLUSION

As the agency vested with the responsibility for acquiring telecommunications services on a competitive basis for use of the Federal Executive Agencies, GSA urges the Commission to implement a five year moving average X-Factor based upon the Historical Revenue Method; allow the LECs to choose between three X-Factors as described herein; modify the sharing mechanism as described herein; and schedule its next price cap performance review in 1998.

Respectfully submitted,

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March 1, 1996

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I, Jody B. Burton, do hereby certify that copies of the foregoing "Reply Comments of the General Services Administration" were served this 1st day of March, 1996, by hand delivery or postage paid to the following parties:

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